Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Poochigian, et al.	Analyst:	Jane Tolman	Bill Number:	SB 1012
Related Bills:	See Legislative History	Telephone:	845-6111	Introduced Date:	02-21-2003
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: NOL Suspension/ Real Estate Withholding Requirements

SUMMARY

This bill would:

1. repeal the suspension of the net operating loss (NOL) deduction for taxpayers subject to the Personal Income Tax Law and accelerate by one year the increase in the allowable NOL carryover percentage to 100%, and
2. revert to prior (pre-2002) law for withholding on real property sales for nonresidents.

The two provisions of this bill will be discussed separately within the analysis.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to lessen the tax burden for taxpayers and to encourage job creation and investment.

EFFECTIVE/OPERATIVE DATE

As an urgency statue, this bill would be effective immediately upon enactment and apply to taxable years beginning on or after January 1, 2003.

POSITION

Pending.

Summary of Suggested Amendments

An amendment is provided to address the department's technical concern. Department staff is available to assist with amendments to resolve the implementation concerns described below.

Board Position:			Department Director	Date
_______ S	_______ NA	_______ NP	Gerald H. Goldberg	4/21/03
_______ SA	_______ O	_______ NAR		
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ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue and cash-flow losses:

Estimated Revenue Impact of SB 1012 As Introduced February 21, 2003 Enacted after 6-30-2003 $ Millions			
	2003-2004	2004-2005	2005-2006
NOL Provision	-$1,000	-$50	-$50
Repeal 3 1/3% withholding	-$225*	-$2*	-$2*
Total	-$1,225	-$52	-$52

* Ultimate tax liabilities are not affected, only the timing of payments.

This estimate does not account for changes in employment, personal income, or gross state product that could result from this bill.

Note: Currently, this bill does not impact corporation tax law. This estimate assumes that the bill will be amended to include corporate taxpayers.

Revenue Discussion

The revenue impact of the NOL provision was estimated as follows. The amount of NOL deductions for each year was simulated based on historical NOL data for both current law and for the provisions of SB 1012. The difference between the NOL deductions that would be claimed under the two sets of laws was then multiplied by an average marginal tax rate on NOL deductions of 5.3%.

The cash-flow impact of the real estate withholding provision was estimated as follows. The cash flow reductions due to the repeal of the current 3 1/3% withholding on real property (residents) was estimated based on the department's 1999 and 2000 capital gains samples. The 1999 and 2000 reductions are extrapolated to 2003 using projected growth rates of real property sales. The cash-flow impact is estimated as the average of these two cash-flow losses.

The term "cash-flow" loss means that while ultimate tax liabilities are not changed, the timing of tax payments through withholding relative to current law by this bill will be affected.

1. NOL Suspension/Percentage

ANALYSIS

FEDERAL/STATE LAW

Federal law provides, in general, that an NOL can be carried back two years and forward 20 years. Special rules are provided for the carryback of NOLs arising from specified liability losses, excess interest losses, casualty or theft losses, disaster losses of a small business, and farming losses. An NOL is defined as the excess of allowable deductions (as specifically modified) over gross income computed under the law in effect for the loss year.

Existing state law conforms to the federal computation of an NOL, except for the following modifications: California does not allow NOL carrybacks. In addition, depending on the type of taxpayer or amount of a taxpayer's income, the percentage of the NOL that is eligible to be carried forward and the number of years it can be carried forward varies.

Existing state law provides for seven different types of NOLs:

Type of NOL	Allowable Carryover	Taxable Years	Carryover Period
General NOL	55% 60% 100%	2000 & 2001 2002 & 2003 2004 - on	10 Years
New Business Year 1 Year 2 Year 3	100% 100% 100%		10 Years
Eligible Small Business	100%		10 Years
Specified Disaster Loss Any remaining excess	100% 55% 60% 100%	 2000 & 2001 2002 & 2003 2004 - on	5 Years 10 Years
Economic Development Areas	100%		15 Years

Note: NOL deductions have been suspended for the 2002 and 2003 taxable years.

THIS BILL

This bill would, under the Personal Income Tax Law (PITL) only, repeal the provision that suspended the NOL deduction for the 2002 and 2003 taxable years and accelerate the NOL percentage of 100% to losses incurred on or after January 1, 2003.

IMPLEMENTATION CONSIDERATION

The department has identified the following concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

Under current law, the NOL deduction applies to both the PIT and Corporation Tax Laws. However, this bill only addresses the PIT side of the NOL. As a result, the current NOL suspension and deductible percentage would continue to apply to corporate taxpayers. The author's office has indicated that it was not their intent to provide inequitable treatment between PIT and corporate taxpayers.

Repealing the suspension of the NOL deduction for the 2002 and 2003 tax years will generate amended returns by taxpayers. Amended returns are slower to process and therefore labor intensive and costly. Since the 2002 income tax returns have already been filed and are currently being processed, the author may wish to amend this provision to repeal the NOL suspension beginning with the 2003 tax year.

TECHNICAL CONSIDERATION

This bill makes numerous technical changes. Specifically, NOL losses attributable to taxable years prior to January 1, 1987, “shall not be allowed” was amended to specify “are allowed.” It is unclear if this was the author’s intent, since only taxpayers with open statutes of limitation going back before January 1, 1987, would be eligible for this change. An amendment is provided to address this concern.

LEGISLATIVE HISTORY

AB 511 (Alquist, Stats. 2000, Ch. 107) incrementally increased the general NOL from 50% to 65% and increased the carryover period from five to ten years.

AB 2065 (Oropeza, Stats. 2002, Ch. 488) suspended the deduction for NOLs, increased the carryover percentage to 100% of the loss for tax years beginning on or after January 1, 2004, and extended withholding on real property to nonresidents.

OTHER STATES’ INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota*, and *New York*. These state were selected due to their similarities to California’s economy, business entity types, and tax laws.

Florida income tax law, with respect to corporations, provides a 20-year carryover period but no carryback, and otherwise conforms to federal NOL laws. *Florida* has no personal income tax.

Illinois income tax law conforms to federal law regarding NOLs.

Massachusetts income tax law does not allow NOL treatment for personal income taxpayers, but corporations are allowed a 100% NOL that applies to the first five years of the entity’s existence.

Michigan income tax law conforms to federal NOL laws, including the allowance of NOL carrybacks for corporations. However, *Michigan’s* personal income tax law does not allow NOL carrybacks.

Minnesota personal income tax law conforms to federal NOL laws, while corporate taxpayers determine NOLs pursuant to federal law but have no NOL carrybacks and only a 15-year carryforward period.

FISCAL IMPACT

To the extent that this bill would significantly increase the number of amended returns filed for 2002, this bill may result in a major impact to the departments return processing. Once the potential volume of amended returns is estimated, a possible cost can be determined.

2. REAL ESTATE WITHHOLDING REQUIREMENTS

ANALYSIS

FEDERAL LAW

Under federal law, 10% of the amount realized on the disposition of a U.S. real property interest must be withheld when a foreign investor disposes of that interest in real property. The withholding obligation is generally imposed on the buyer or the withholding agent, who must report the amounts withheld and pay them to the Internal Revenue Service.

STATE LAW PRIOR TO JANUARY 1, 2002

Prior to January 1, 2002, for individuals under state law, when California real estate was sold by a nonresident of California, buyers were required to withhold 3 ⅓% of the total sales price unless a withholding exemption was applicable or the Franchise Tax Board (FTB) authorized a waiver or reduction in the withholding amount.

Generally, the buyer was required to withhold when purchasing California real property if any of the following applied:

- the seller's last known mailing address was outside California,
- the disbursement instructions authorized proceeds to be sent to a financial intermediary of the seller, or
- the seller was a corporation with no permanent place of business in California immediately after the sale.

Withholding was not required if any of the following applied:

- the total sales price of the California real property was $100,000 or less,
- the buyer did not receive written notification of the withholding requirements,
- the sellers certified that they were residents of California,
- the seller was a corporation that certified it had a permanent place of business in California immediately after the transfer,
- the sellers certified that the property conveyed was their principal residence,
- the seller was a bank or a bank acting as a fiduciary for a trust,
- a corporate beneficiary under a mortgage or deed of trust was acquiring the property in foreclosure or by deed in lieu of foreclosure,
- the seller was a partnership and title to the property was recorded in the name of the partnership,
- the seller was a limited liability company classified as a partnership for California tax purposes, and title to the property was recorded in the name of the limited liability company,
- the seller was exempt from tax under either California or federal law,
- the seller was an estate that certified the decedent was a California resident at the time of death,
- the seller was an irrevocable trust that certified at least one trustee was a California resident, or
- the seller was an insurance company, an IRA, or a qualified pension/profit-sharing plan.

Requests for waivers or reduced withholding were submitted to FTB. All waiver requests were handled on a case-by-case basis. Generally, requests for waiver or reduced withholding were granted when:

- there was little or no gain on the transaction,
- the amount otherwise required to be withheld (3 1/3 % of the sale price) exceeded the tax on the recognized gain,
- the transaction involved a like-kind exchange,
- the sale was to be reported on the installment sale basis,
- the transfer was the result of a foreclosure by an individual,
- the transfer was the result of an involuntary conversion and the transferor intended to replace it with qualified property,
- the transaction involved multiple sellers and some, but not all, were California residents, or
- the transaction involved property that was recently acquired by inheritance or through an estate distribution.

<u>STATE LAW AFTER JANUARY 1, 2002</u>

AB 2065 (Oropeza, Stats. 2002, Ch. 488) changed the statute on real estate withholding by expanding the provisions to include dispositions of real property by resident individuals and by replacing the waiver process with self-certification.

Under current law, when California real property is sold, buyers are required to withhold 3 1/3% of the total sales price if any of the following apply:

- the seller is an individual or a trust, or
- the seller is a corporation that has no permanent place of business in California immediately after the sale of the real property.

For individual sellers, withholding is not required if any of the following apply:

- the total sales price of the California real property is $100,000 or less,
- the buyer did not receive written notification of the withholding requirements,
- a corporate beneficiary under a mortgage or a deed of trust is acquiring the property in foreclosure or by deed in lieu of foreclosure, or
- the seller certifies under penalties of perjury that:
  - the property conveyed was their principal residence,
  - the property is being exchanged under the like-kind exchange provisions of IRC Sec. 1031,
  - the property was involuntarily converted or sold and the seller intends to replace the property within the meaning of IRC Sec. 1033, or
  - the sale results in a loss to the seller.

The withholding may be modified if income from the property that is sold is taken into account under the installment method of accounting.

For corporate sellers with no permanent place of business, withholding is not required if either of the following apply:

- the total sales price of the California real property is $100,000 or less, or
- the buyer did not receive written notification of the withholding requirements.

Corporate sellers with no permanent place of business in California, may request a withholding waiver or a reduction in the amount of withholding from FTB. All requests for a waiver or reduced withholding are handled on a case-by-case basis. Generally, requests are granted when:

- there is little or no gain on the transaction,
- the amount otherwise required to be withheld (3 1/3% of the sale price) exceeds the estimated tax on the recognized gain,
- the transaction involves a like-kind exchange,
- the sale will be reported on the installment sale basis,
- the transfer is the result of a foreclosure,
- the transfer is the result of an involuntary conversion and the transferor intends to replace it with qualified property under IRC sec. 1031,
- the transaction involves property that was recently acquired by inheritance or through an estate distribution, or
- the seller is a corporation that certifies it has a permanent place of business in California immediately after the transfer.

THIS BILL

This bill would replace the current real estate withholding statute with the statue that was in place prior to January 1, 2002. That is, the withholding requirements would only apply to nonresident taxpayers of California and waivers would be available upon request.

IMPLEMENTATION CONSIDERATIONS

AB 2065 substantially modified the withholding on real property sales. This was accomplished by amending the provisions relating to both the imposition of withholding and the penalties for failure to withhold. The present withholding regime is dependent on these two provisions working together. This bill only amends the statute that relates to the imposition of withholding. Without modifications to the penalty statute, the department would be unable to administer the real estate withholding program. For example, this bill provides that buyers only withhold on nonresidents, while the penalty provision, unchanged by this bill, provides a penalty on buyers for not withholding on residents. The author may wish to amend the penalty provision in order to provide consistency between the two provisions.

Under current law, the department has begun collecting withholding from affected taxpayers. This bill would be operative January 1, 2003, which would require the department to refund the withholding that was collected. It is unclear when the department would be required to generate the refunds. The author may wish to add language specifying when FTB would be required to refund the withholding that has been collected.

Implementing this provision would significantly impact the department's programs and operations since changes to the systems and forms have already been made and staff has been hired and trained for this workload. In addition, due to the retroactive effective date for real estate transactions on or after January 1, 2003, the department would be required to expedite an outreach effort to educate escrow officers and real estate agents on the reversal of the withholding provision.

LEGISLATIVE HISTORY

AB 2065 (Oropeza, Stats. 2002, Ch. 488) expanded the real estate withholding to residents and converted the waiver process for individuals into a self-certification process.

AB 628 (Runner, 2003) would eliminate real estate withholding on sole proprietors in the trade or business of constructing and selling residential houses. This bill is currently in the Assembly Revenue and Taxation Committee.

AB 1490 (Benoit, 2003) would eliminate real estate withholding on all residences of the seller regardless whether the residence qualifies as the seller's principal residence. This bill is currently in the Revenue and Taxation Committee and is scheduled to be heard on April 21, 2003.

AB 1338 (Chavez, 2003) this bill would modify the real estate withholding provisions, require withholding on the portion of any gain, and revise other withholding provisions affecting certain corporations and real estate. This bill is currently in Revenue and Taxation Committee and is scheduled to be heard on April 21, 2003.

OTHER STATES' INFORMATION

The laws of *Illinois, Massachusetts, Michigan, Minnesota*, and *New York* were reviewed because their tax laws are similar to California's income tax laws. No statutes were found for these states where a withholding requirement is imposed on the sale of real property similar to California's present real estate withholding law or as proposed by this bill.

FISCAL IMPACT

Due to the implementation considerations, costs cannot be determined at this time. If the bill continues through the legislative process, costs will be identified and a deficiency request will be submitted.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 1012
As Introduced February 21, 2003

AMENDMENT 1

On page 3, line 19, after "are" insert:

not